

THE ECONOMIC REPORT OF THE PRESIDENT

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

FEBRUARY 10, 2004

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THE ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 10, 2004

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met at 2:30 p.m. in room SD-628 of the Dirksen Senate Office Building, the Honorable Robert F. Bennett (Chairman of the Committee) presiding.

Senators present: Senators Bennett, Sarbanes, and Reed.

Representatives present: Representatives Paul, and Maloney.

Staff members present: Mike Ashton, Gary Blank, Nan Gibson, Colleen Healy, Brian Higginbotham, Brian Jenn, Rachel Klastorin, Donald Marron, Wendell Primus, Matthew Salomon, Frank Sammartino, Chad Stone, and Rebecca Wilder.

OPENING STATEMENT OF HON. ROBERT F. BENNETT, CHAIRMAN, A U.S. SENATOR FROM UTAH

Chairman Bennett. The hearing will come to order.

We appreciate everyone's attendance here today. We welcome you to this hearing on the Economic Report of the President.

This meeting is the one meeting that is absolutely required by legislation. Congress created this Committee, the Joint Economic Committee, and the President's Council of Economic Advisers at the same time by law in 1946 and in that legislation mandated that the Council issue an Economic Report every year and officially present it to this Committee.

So today's hearing is the time when we comply with that Congressional requirement. And we will hear directly from the authors of the President's Economic Report and discuss with them the economic issues that face us today.

The last few years have dealt us a series of blows. We had an already weakening economy that was then hit by terrorism and corporate scandals and increased requirements for homeland security and defense. Despite what someone might call a "perfect storm" of economic difficulty, recent economic indicators tell us what many have already been feeling—and that is, that the economy is now experiencing the first stages of a strong recovery. 2003 ended with very strong growth, averaging 6.1 percent in growth in the GDP in the second half, which is the fastest growth in consecutive quarters since 1984.

The unemployment rate continues to fall. Manufacturing activity is increasing. And stock prices continue to rally. Over the next year we can look forward to a robust economy and the job creation that will follow.

But what we must focus on now, I believe, is not only what's happening today, but what we will be facing 10 years and beyond.

Recent budget projections have spurred a lot of discussion about the deficit. And I think we should examine this discussion by acknowledging that budget forecasters, however well educated and well meaning, are giving us an educated guess at best.

I say over and over again, when presented with a budget forecast or a deficit forecast or a surplus forecast, I don't know what the surplus will, in fact, be a year from now. All I know is that the number that we have before us is wrong. I don't whether it will be wrong on the high side or the low side, but I can be absolutely certain that it will be wrong.

And this last year has been no exception to that rule.

The final number that came in for fiscal 2003 was \$80 billion less than the projected deficit earlier in the year. And \$80 billion sounds like a huge amount of money and therefore a very, very large error. To put it in perspective, it is about 3 percent of the size of the total Federal budget and it is .007 percent of GDP.

A forecaster that can come within 3 percent of what is going to happen in the future could have a significant career as a pollster because that number is within the margin of error.

That does not mean we should dismiss the deficit. In the near term it is large but manageable. If we again measure it against something instead of just take the total number, deficits I believe should always be measured relative to the size of the economy in order to account for the economy's capacity to absorb them and the Government's ability to finance them.

When measured as a percentage of GDP today's deficits are still below the peaks of the 1980s and the 1990s. However, continued increases would pose significant economic problems. We must therefore turn our attention to Federal spending, where recent growth rates are clearly unsustainable.

We need to slow the growth of discretionary spending—where all of the conversation takes place for sure. But we must recognize that this discretionary spending is less than half of the equation.

The majority of the spending that we do in this country is mandatory spending for entitlement programs. And the biggest problem we face in the long run is escalating mandatory entitlement spending.

According to the President's budget and other studies that have been done, particularly by the GAO, entitlement spending is on track, if we don't do anything about it, to increase from 10 percent of GDP, where it currently is, to more than 20 percent in coming decades.

Historically since the end of the Second World War, tax revenues have been below 20 percent. This means that entitlement spending could consume the entire tax revenue of the country if we don't do something about it. That means we would not have any money left for anything else but entitlements.

So long-run fiscal discipline demands that we consider serious reform of the massive spending growth connected with mandatory spending.

One of the primary reasons that we are facing this and must address the enormous burden that will come on our economy from

this increase, is that the baby boomers will begin to retire towards the end of the decade and move into an area where, instead of sending money to the Government in the form of taxes on their wages, they will start receiving money from the Government in the form of these entitlements.

As these men and women retire, the Nation faces a serious challenge with fewer workers available to support each retiree.

We need only to look towards Europe, where they are having this effect occur in their demographic pattern more sooner than we will, to see how devastating this can be, as more and more European countries that previously sustained a very significant welfare state are now making serious cutbacks in that activity. We need to plan a little better than some of the European countries have done.

We will see increasing pressure on Social Security and Medicare and we need to undertake a serious review of these programs to see where reforms and savings might be obtained.

I know some have suggested, and I expect that they will here today, that the way to return to fiscal discipline in their view would be to allow the President's tax relief to expire in the years ahead.

If I may, I think that is short-sighted. Rescinding the tax relief would do little to improve the long-run fiscal situation that I have described, but it would, in fact, in my view stifle the recovery that is just taking hold today.

The tax cuts had an immediate beneficial effect on the economy and contain important elements to encourage work, saving, and investment and keep the current recovery going for years to come.

I don't think we should short-circuit these powerful incentives by allowing these tax cuts to expire. People need to be able to plan for their financial future. They can't do that if they don't know what the tax laws will be from one year to the next.

[The prepared statement of Senator Bennett appears in the Submissions for the Record on page 31.]

Chairman Bennett. With that, may I welcome the members of the Council of Economic Advisers, Dr. Greg Mankiw, who is Chairman of the Council, and Drs. Harvey Rosen and Kristen Forbes, members of the Council. We've enjoyed working with you and your team in the past. We look forward to further cooperation.

And the other Members of the Committee and I are anxious to hear your thoughts about the current state of the economy and the various proposals and policy reforms presented in your Annual Report.

Mr. Stark is unable to be with us, so we are happy to recognize Mrs. Maloney in the role of the Ranking Member here on the Joint Committee.

**STATEMENT OF HON. CAROLYN B. MALONEY, A U.S.
REPRESENTATIVE FROM NEW YORK**

Representative Maloney. Thank you so much, Chairman Bennett. And I also want to thank you for holding this hearing, which continues a JEC tradition of having the Council of Economic Advisers present to discuss the Economic Report of the President.

I want to welcome Dr. Mankiw, as well as Dr. Forbes and Dr. Rosen.

This is a big Report with a very slick cover and a lot of chapters, but there is one chapter that is missing. That is the chapter that explains why it is good economic policy to lose over two million jobs and to completely squander the climate of fiscal discipline that President Bush inherited.

As the *New York Times* recently noted in one of their editorials, Republicans have become a band of “budget buccaneers” lacking any fiscal integrity.

The President makes the hollow promise to cut the budget deficit in half in 5 years. But the Administration clearly has no serious plan to address the deficit, which is still projected to be \$521 billion in 2004. While it is true that both the Administration and the Congressional budget office estimate that the deficit will fall as a share of GDP over the next 5 years with no new policy changes, long-range projections show that this is a temporary improvement and budget deficits will explode with the retirement of the baby boom generation. The Administration’s proposed policies make the 5-year deficit worse than it would be with no policy changes. Moreover, making all the President’s tax cuts permanent will seriously worsen deficits beyond 2009.

This is hardly a picture of fiscal discipline. The Administration’s budget submitted last week really should be given a grade of incomplete for omitting many likely policy changes and presidential policies that will make the deficit even worse. For example, it leaves out funding for Iraq and Afghanistan, the cost of fixing the alternative minimum tax, and the true cost of the President’s vision to send humans to Mars and his plan to privatize Social Security. And while the Bush budget continues to include large and unaffordable tax cuts, the Administration’s unwillingness to provide budget figures beyond 2009 hides the true cost of these tax cuts.

The Administration continues to argue that our Nation’s fiscal deterioration is due almost entirely to events beyond its control, namely the economic recession and the wars in Iraq and Afghanistan. But the facts are that the tax cuts already passed are responsible for a third of the deterioration of the budget outlook for 2004 and 2005. If the tax cuts are to be made permanent, this share would only increase in time.

Dr. Mankiw is on record in his textbook and academic research as arguing that persistent large budget deficits are harmful to the economy. I would be interested in knowing what advice, Dr. Mankiw, you’ve given the President with respect to these ballooning deficits.

There is another deficit that I am concerned about, the jobs deficit that President Bush has presided over. A year ago the Administration estimated that nearly two million jobs would be added in the second half of 2003—510,000 of them due to the President’s tax cut. Yet, in fact, less than 200,000 jobs were created during that period. To its credit the Economic Report of the President acknowledges that job performance has been disappointing. On page 48 the Report says, and I quote: “Indeed the performance of employment over the past couple of years has been appreciably weaker than in past business cycles. It has lagged even that of the so-called jobless recovery from the 1990–91 recession.”

Instead, President Bush is on track to be the first President since Herbert Hoover to end his term with fewer jobs than when he started. We've been gaining jobs slowly since August, but at the pace we've seen so far it would take nearly 2½ years to erase the current job deficit. President Bush, would end his term January of 2005 with a deficit of nearly 1.5 million jobs. Job creation would have to average 186,000 jobs per month from February 2004 to January 2005 just to erase the current 2.2 million Bush job deficit completely. We are a long way from that and even farther away from full employment.

References to foreign outsourcing in the Economic Report of the President are troubling. I have over here some of the comments on the topic that have not been well received by my colleagues and I'd like to refer to today's headlines in the *L.A. Times*: "Bush Supports Shift of Jobs Overseas." These are direct quotes. *Seattle Times*: "Bush Report Sending Jobs Overseas Helps U.S." *The Pittsburgh Post-Gazette*: "Economic Report Praises Outsourcing Jobs." *Orlando Sun* in Florida: "Outsourcing Jobs Abroad Can Be Beneficial."

We need to know how much the President's tax and trade policies have contributed to job losses over the last 3 years. We also need to see this Administration demonstrate more compassion to the workers who have been hurt by this trend.

House Democrats last week forced the passage of legislation that would restore temporary Federal unemployment insurance benefits that President Bush and the Republican-controlled Congress allowed to expire over Christmas. Following the 1990-91 recession the Administration of President Bush's father provided 20 weeks of temporary Federal unemployment benefits in all States until 1.6 million jobs had been created. While the President has pledged to extend his tax cuts, he has no plans to extend jobless benefits for the long-term unemployed. This is hardly a picture of compassionate conservatism.

In short, this year's Economic Report of the President ignores the biggest issues before us: the jobs deficit and the budget deficit.

I look forward to hearing from Chairman Mankiw and his colleagues. I look forward to your testimony and I hope that you will address the concerns that the Democrats have raised.

Thank you very much.

[The prepared statement of Representative Maloney appears in the Submissions for the Record on page 32.]

Chairman Bennett. Tempting as it might be to enter into a debate at this side of the rostrum on the comments, I think we'll leave the opening comments on both sides as they've been made and turn immediately to the panel.

Chairman Mankiw, you may proceed.

STATEMENT OF DR. N. GREG MANKIW, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Dr. Mankiw. Chairman Bennett, Mrs. Maloney, Members of the Committee I am delighted to be here to discuss the release of the Economic Report of the President and the current challenges facing economic policy. The Economic Report released today covers a wide range of issues including recent business cycle developments, tax

policy, health system regulation, and the role of the United States in the world economy.

I will spend a few minutes giving a macro overview of the economy. And I will leave microeconomic issues to my colleague Dr. Rosen and international issues to my colleague, Dr. Forbes.

Over the past few years the economy has had to deal with several major contractionary shocks: the end of the stock market bubble, corporate governance scandals, terrorist attacks, and slow growth among our major trading partners, particularly Japan and much of Europe.

These shocks led to a recession. As judged by GDP, the broadest measure of economic activity, the downturn was mild by historical standards thanks to expansionary monetary and fiscal policy.

Manufacturing was hit particularly hard, however, and this phenomenon is discussed extensively in the new Economic Report.

Since the last Economic Report was released a year ago, the United States economy has gotten stronger. Over the four quarters of 2003, real GDP grew at a rate of 4.3 percent, significantly above the average growth rate since 1960 of 3.3 percent.

This growth was particularly strong in the second half of the year after the passage of the jobs and growth tax relief bill. The last two quarters of 2003 showed the most rapid growth of any 6-month period in nearly 20 years.

The labor market is also starting to improve. Since August the economy has created 366,000 jobs. The unemployment rate has fallen from a peak of 6.3 percent to 5.6 percent.

Like most private sector economists, the Administration forecasts continued growth in GDP and employment in the year ahead. The future of the United States economy is bright. This is a testament to the institutions and policies that have unleashed the creativity of the American people and their spirit of entrepreneurship.

History teaches that the forces of free markets are the bedrock of economic prosperity. In 1776 as the Founding Fathers signed the Declaration of Independence, the great economist Adam Smith wrote: "Little else is required to carry a state to the highest degree of opulence and the lowest barbarism but peace, easy taxes, and a tolerable Administration of justice, all the rest being brought about by the natural course of things."

The economic analysis presented in this Report builds on the ideas of Smith and his intellectual descendants by discussing the role that the Government has in creating an environment that promotes and sustains economic growth.

Thank you. I look forward to taking your questions.

[The joint statement of Dr. Mankiw, Dr. Forbes, and Dr. Harvey S. Rosen appears in the Submissions for the Record on page 33.]

**STATEMENT OF DR. HARVEY S. ROSEN,
MEMBER, COUNCIL OF ECONOMIC ADVISERS**

Dr. Rosen. Senator Bennett, Ms. Maloney, Members of the Committee: Thank you for the opportunity to testify on the 2004 Economic Report of the President.

My focus will be on the chapters that deal with domestic microeconomics. By microeconomic issues I refer to questions relating to how society allocates its scarce resources among alternative uses.

These chapters deal with a very broad range of topics including the environment, energy, health care, the tort system, and the evaluation of tax policy.

Diverse as these topics are, our treatment of them is unified by the following themes. First, an important reason for Americans' high standard of living is that they rely primarily on markets to allocate resources. Typically, free markets allocate resources to their highest valued uses, avoid waste, prevent shortages, and foster innovation.

Second, importantly, no one directs society to this result. Rather it is the outcome of a process in which each consumer and each producer makes a decision that maximizes his well-being. Prices coordinate economic activity by providing signals of the costs to society of providing various goods.

Third, however, under certain circumstances market prices may fail to allocate resources efficiently. Under these circumstances well-designed Government interventions may enhance efficiency. Well-designed interventions must take into account how consumers and businesses will react to them.

Fourth, the fact that the market-generated allocation of resources is imperfect does not mean the Government is necessarily capable of doing better. In some cases, for example, the cost of setting up a Government agency to deal with the problem might exceed the costs imposed by the problem itself.

Thank you for the opportunity to testify. I look forward to your questions.

Chairman Bennett. Thank you.

Dr. Forbes.

**STATEMENT OF DR. KRISTEN J. FORBES,
MEMBER, COUNCIL OF ECONOMIC ADVISERS**

Dr. Forbes. Chairman Bennett, Mrs. Maloney, and Members of the Committee, thank you for inviting us to testify today. My comments will focus on the section of the Economic Report of the President covering international economics.

Increased trade has stimulated United States and global growth. This is true not only for traditional forms of trade, but also for new types of trade—for example, in services such as banking or movies.

The United States has pursued an ambitious agenda of trade liberalization and has been a central force in constructing an open global trading system.

Since foreign competition can also require adjustments, the Administration has developed and strengthened programs to assist workers and communities negatively affected by trade.

International capital flows, as well as international trade, can generate substantial economic benefits. Capital flows have become an increasingly significant part of the world economy, an important source of funds to support investment in the United States.

Although international trade and capital flows are often discussed separately, they are closely intertwined. For example, in the United States the large net inflow of foreign capital in recent years corresponds to the large current account deficit.

These patterns reflect fundamental economic forces—notably, strong growth in the United States that has made investment attractive compared to in other countries.

Public policies can smooth any changes in the United States current account and net capital flows by creating a stable macro and financial environment, by promoting growth abroad, and by encouraging savings in the United States.

I look forward to answering your questions.

Thank you.

Chairman Bennett. Thank you all.

Dr. Mankiw, you referred to the recession as relatively mild by historic terms. It didn't feel like that in many places in the country. It felt fairly deep and fairly bitter. And we've already seen one revision by the Bureau of Economic Analysis—unfortunately they always do it after the fact by some significant time lag—showing three quarters of negative growth. And now they've said that there was a quarter of negative growth before the three quarters started.

And in your Report there is the assumption that the recession in fact began in the last quarter of 2000. Do you want to expand on that just a little so that as to look back we try to get a clearer picture of what really happened?

Dr. Mankiw. The official arbiter of when recessions begin and end is the National Bureau of Economic Research, as you've said. And they originally put the beginning of a recession, the peak, in March of 2001. Since then the data has been revised. And what we do is we document the revisions in a box in chapter of one of the Economic Reports.

And all the data revisions have moved in the direction of saying that the peak was likely earlier. The Bureau has suggested that they would revisit this issue when the full set of data is in and decide exactly when the date is.

Our look at the data suggested that the fourth quarter of 2000 looked like the most likely date for the peak given the data that we have now. But, as I mentioned, not all the data is in. And as more data comes in, the National Bureau will have the opportunity to revisit their decision.

Chairman Bennett. Well, if that is the case, that means we had four full quarters of negative growth.

Dr. Mankiw. Yes, in terms of the question of whether the recession was mild or not, there's different ways of looking at it.

Chairman Bennett. I realize it was relatively mild. It wasn't nearly as deep as the recessions that preceded it, but it may have been longer than we had previously thought.

Dr. Mankiw. Yes, yes. There was a negative quarter, then a positive quarter, and three negative quarters according to the current—

Chairman Bennett. So if that positive quarter by review of the data turns negative, then you'll have five successive negative quarters. And that's a pretty long stretch to try to come out of. And that might explain why the recovery is having so much trouble getting underway.

Because the previous thought was, well, it was very shallow and very short. Why shouldn't we go immediately to back to where we were? If, in fact, we're talking about five successive quarters, how-

ever shallow they may have been, that's a pretty heavy hit to have to absorb in order to get job creation and so on off the ground. Is that a fair characterization?

Dr. Mankiw. That's correct. And another feature in terms of job creation is we have had very rapid productivity growth. And rapid productivity growth sort of raises the bar that the economy needs to jump over to get job growth going.

I mean, the economy is stronger with higher productivity growth. And that eventually leads to higher real wages and higher living standards. But it does sort of raise the bar that we need to jump up over to get the labor market going.

Chairman Bennett. They tell me my clock is not running, so I'll have to watch yours. Maybe I won't watch any at all. I'll just go on and on.

Could you respond, any of you, to some of the comments that were made in the opening statement about the loss of jobs? We've held several hearings on the disparity between the household survey and the payroll survey, both of which are conducted by the Bureau of Labor Statistics.

These are not competing organizations. This same organization is telling us at one time that we've lost two and a half million jobs and at the same time data suggests that we have added a million and a half. This is a 4 million gap, which has never occurred before in our history.

Do you have—any of you—any feeling about what is causing this statistical anomaly? Obviously in a political year where people are running for office, some will stress the lower and talk about Herbert Hoover. And others will stress the higher and talk about Ronald Reagan.

So where indeed are we? Do you have any feel for this?

Dr. Mankiw. I think the way to think about economic statistics is that all of them are imperfect. It is a mistake to emphasize any single statistic or data series to the exclusion of others.

What we've seen in the statistics in the labor market is that around the summer they've all sort of turned around. The labor market is getting better. But different statistics point to them getting better at different rates.

As you correctly point out, the survey of firms, the so-called payroll survey, shows smaller job gains than the household survey, which generates the unemployment rate. If you look at other indicators like the falling claims for unemployment insurance, they seem more consistent with the household survey.

On the other hand, the payroll survey is based on a larger sample. And all things being equal, you prefer larger samples to smaller samples. I don't look at any one series at the exclusion of the others. You sort of have to look at the entirety.

It may well be true that we'll understand this difference over time. I think right now it's a puzzle. We understand some of it. We understand, for example, that the self-employed show up in the household survey, but not in the payroll survey. But we know that's not the full explanation.

I think part of that discrepancy, which is very large, as you pointed out, is a puzzle. And it will generate Ph.D. dissertations in the future no doubt.

Chairman Bennett. Yeah, we can't get at it at this hearing here. I will just say that my own conviction is that something fairly fundamental, indeed structural, is going on in this recovery that has never gone on before and that the ways in which we measure the recovery are proving to be faulty. Therefore, all of us need to be a little humble as we start yelling statistics at each other. It may well be that the statistics are wrong.

If there is the kind of structural change in job creation that I think is going on, I don't think the payroll survey is necessarily reliable, long-term indicator of what's happening in the economy.

As more and more people end up in places less traditional than gets measured by the payroll survey, it may have a large sample, but the universe which is sampling is changing to the point that it is leaving out a portion of the economy that's growing very rapidly. And we could, in fact, be seeing much more job creation than that number represents. That's just my own view.

Ms. Maloney.

Representative Maloney. Thank you very much, Mr. Chairman.

Dr. Mankiw, the Counsel of Economic Advisers under your predecessor, R. Glenn Hubbard, issued a Report forecasting that the economy would add nearly two million jobs in the second half of 2003, about 500,000 of them contingent on our enacting the President's proposed tax cuts.

And Congress did do what the President wanted. He got his tax cuts. How many jobs were actually added in the second half of 2003?

Dr. Mankiw. I don't have that precise number, but you are right that the labor market was weaker than the Council and the private sector forecasters were expecting a year ago.

Representative Maloney. And you don't have those numbers at all anywhere in your Report?

Dr. Mankiw. I don't have the precise numbers. On page 98 of the Report we do have some for 2003. What I have here is your average numbers. The payroll employment went from 130.4 in 2002 on average to 130.1 in 2003 on average, although I should note that this data was as of—when our forecast went to bed on December 2nd. I think those data have been revised since then.

Representative Maloney. Could you get for the Committee the actual numbers?

Dr. Mankiw. We can get the numbers for you. Yes.

Representative Maloney. Thank you very much. What is the level of payroll employment now, compared with what it was when President Bush took office?

In your Report on page 98 it appears that you are relying on the payroll survey. However, the Bureau of Labor Statistics views the establishment survey, the payroll survey as a more accurate indicator of labor market conditions.

What is the level of payroll employment now compared with what it was when President took office? Don't we have a job deficit of 2.2 million? And isn't that deficit merely 3 million when we focus on merely the private sector jobs?

Dr. Mankiw. You're absolutely right that the labor market has been weak. And that is something that deeply concerns the Presi-

dent. The President has said to me many times that his first economic priority has been to put America back to work. That's been very much the focus of the economic policies he's put in place.

I think we're starting to see the results of that. I think the labor market has turned the corner this summer.

But we still have a ways to go. We want to see more jobs created. We want to see the unemployment rate continuing to go down. And I expect that will happen over the coming year, as do most private sector forecasters.

Representative Maloney. So do I. I hope we see that. But how many jobs do we have to create each month just to keep up with the growing labor force, much less recover those 2.2 million jobs?

Dr. Mankiw. The population in the labor force tends to grow about 1 percent a year. The labor force also depends on labor force participation.

Representative Maloney. So that comes down to how many jobs?

Dr. Mankiw. I don't have that exact number in front of you. About 125,000 my staff tells me. And that sounds about right.

Representative Maloney. Okay. How many jobs per month have we created since job growth turned positive last August?

Dr. Mankiw. As I mentioned in my opening remarks, we've created 366,000 in the past five months.

Representative Maloney. So that's how much per month?

Dr. Mankiw. That's about 73,000 a month if my arithmetic is correct.

Representative Maloney. So half the required pace. And is it fair to say that this has been the longest and most persistent jobs recession since the 1930s and that we have yet to see a month with satisfactory job growth?

Dr. Mankiw. We're not satisfied with what's going on in the labor market. You're right about that. We——

Representative Maloney. Has it been the most persistent jobs recession since the 1930s?

Dr. Mankiw. I haven't compared every single one. So I don't know the answer to that question. But there's no question that it has been a recession that——

Representative Maloney. You're a famous economist. Could you compare it and get it to us in writing?

Dr. Mankiw. Yes, we could.

Representative Maloney. Thank you very much.

Representative Maloney. Looking ahead, the CEA is forecasting that the payroll employment this year will average 132.7 million jobs. And that is about 2.5 million more jobs than we have now. And that's an average. So we should reach that level in June or July, correct?

Dr. Mankiw. Under this forecast we should expect substantial job increases. We don't have a specific month in which we're going to reach that number. That's an annual average. We do expect jobs to be coming back. And we do expect a robust labor market going forward.

Representative Maloney. But if you follow the average that you projected, it would be June or July.

And lastly, I'd like to ask on the jobs, do you really believe the economy is so strong that it will add 425,000 jobs per month in the next six months?

Dr. Mankiw. No, 425,000 is not the number we're forecasting.
Representative Maloney. What are you forecasting then?

Dr. Mankiw. Well, do you see the numbers in front of you? If you add the annual averages up, it is 2.6 million more on average in 2004 than on average in 2003. I should note by the way, that in interpreting that number, it's important to——

Representative Maloney. So if you're going to get the annual average, you've got to have the 425,000 jobs per month in the next six months.

Dr. Mankiw. No, that is not correct arithmetically. But the thing I want to point out is this is forecasting only about 3 percent of growth in the number of jobs over next year. That is about average for a recovery.

It's above the recovery we saw in the early 1990s, but significantly below the recovery we saw in the early 1980s. So it's a very plausible forecast.

I should note, the specific numbers in that table you're referring to were determined in early December before several employment releases and before the recent data revision. Some of the news reports on that have sort of been comparing sort of apples and oranges by comparing those numbers in the table to post-benchmark numbers from the Bureau of Labor Statistics.

Representative Maloney. I guess the main point is is that it was forecast that you'd create 2 million last year. You didn't. The main point is we are nowhere near making up the number of jobs that we have lost. And there's a credibility gap.

Chairman Bennett. Mr. Paul.

Representative Paul. Thank you, Mr. Chairman.

I wanted to follow up on a comment you made earlier, Mr. Chairman, relating to the mandatory spending versus the discretionary spending, which I think is a very important point and something that, if we don't eventually address, I think it's going to be impossible to get our budget in order.

I don't think there was ever anything intended originally in our history that said that previous Congresses should be able to dictate to us what we spend.

As a matter of fact, I find fault with that and think that that has to be challenged some day because it's easy for Members of Congress to just write it off and say that's mandatory; I can't do anything about it.

But the way I look at it, I'm responsible for every dollar spent this year because I'm voting on it. And I think that eventually has to change.

I also would like to suggest that we do need some deficit hawks around here. The deficit is out of control.

But I think there's something equally important—and that is the total amount of Federal spending. As a matter of fact, if spending is going up and we balance the budget next year with raising taxes, you could say that is being a deficit hawk. But that could be very devastating as well.

And I would like to emphasize that total Government spending is something we have to keep our eye on.

But I want to develop a question around the ideas of the free market economists, who have actually come to the conclusion that the predictions about future economic growth in the economy is based on a fiction.

And the fiction is that we have deceived ourselves into believing that all we have to do is borrow more money and print more money and everything is going to be okay without a significant amount or an adequate amount of liquidation of previous debt and previous mal-investment and that there's no reason to think that we might not move into an economy somewhat similar to what Japan has been involved in, because the spending and printing doesn't solve their problem.

Right now the consumers—how can we expect the consumers to borrow more? They are nearly \$2 trillion in debt. They have a credit card debt that's \$7,000 in debt per household. Total debt in this country is \$34 trillion and 21 percent of that has developed since 1990.

So we're on a radical increased scale. I mean, it is expanding exponentially. The current account deficit along with our domestic debt now is over \$1 trillion. And that's 10 percent of the GDP.

We are required to borrow \$2 billion a day from foreigners to finance our extravagant living, both Government and consumers. And we consume—our Nation consumes 8 percent of the world's savings. So the idea that we can encourage consumers to borrow more and bail us out I think is really a fiction.

Our savings rates, our policies, the way we have our tax policies, and the way we devalue our money—there's no incentive to save. So even the BEA just recently readjusted the saving estimate—and they're lower than ever.

So we don't save. So we don't have a capitalist system. We don't save and use our capital. We depend on the creation of new money and credit by the Federal Reserve to get our capital.

And that's a dependency that someday we have to look at, because all it does is encourage artificial interest rates, mal-investment, and perpetuates a debt bubble that has not liquidated itself.

And the business cycle theory, according to the free market economists, claim that you cannot solve the problem of too much debt and too much inflation, with more debt and more inflation, especially if you haven't had the liquidation that is generally the case.

This has to lead to one thing—and that is the dollar has to go down. And the dollar is going down. But instead of protecting the savers and protecting those who want to import at good prices—and the consumers—we say it's wonderful; it's going to bail us out.

I think that is a fiction. And I would like you to convince me otherwise.

Dr. Mankiw. Okay, you make some very important points. On the deficit I think we agree that it needs to come down. The President agrees it needs to come down. He's put forward a budget, in which it will come down over the next 5 years.

But longer term, in terms of mandatory spending, this becomes an issue that Chairman Bennett and Ms. Maloney have also men-

tioned. There is a very important public policy issue regarding the long-term trajectory associated with the entitlement programs, Social Security, and Medicare. We have a chapter in the Economic Report on Social Security.

There's no question that the current trajectory they are on is not sustainable for future generations. That's why the President has repeatedly called for the need to modernize these programs to make sure they are sustainable for future generations because the path they're on now is not sustainable. And we agree with that. And there's a whole chapter in the Economic Report of the President making that point.

On the current account deficit, let me defer to my colleague, Dr. Forbes, who is sort of our expert in international economics.

Dr. Forbes. You're right in that the current account deficit in the United States is large. And the United States has been borrowing a large amount from other countries. The deficit reached about 5 percent of GDP last year.

But in and of itself a large current account deficit isn't bad. And it's important to look at a number of other factors.

One is the total sum of borrowing accumulated from the past. Actually in the past the United States has lent abroad for many years. I mean, it's only recently the United States has started to borrow from abroad in net. So if you look at the total net debt owed to foreigners in the United States, it's actually quite low by cross-country standards.

Another factor to consider is that the United States current account deficit is balanced by net capital inflows, as with any country with a floating exchange rate. And foreigners have been very happy to invest in the United States and finance the current account deficit because of the strength of the United States economy.

Investors see the United States as a very attractive investment opportunity especially in the past few years as growth in the United States has consistently outperformed growth in other countries.

So therefore in some ways the current account deficit is a symbol of the strength of the United States economy rather than a weakness. And it's important to think about all those factors when evaluating whether it's a concern.

Representative Paul. I'd like a follow-up, but my time is up.

Chairman Bennett. Senator Sarbanes.

Senator Sarbanes. Thank you very much, Mr. Chairman. I want to welcome the members of the Council here.

The Administration has been constantly lowering its forecast for jobs, and I want to ask the witnesses about that. The forecast for the number of jobs that we would have in calendar 2004, the calendar year in which now find ourselves, was 138.3 million in the 2002 Economic Report.

And if you disagree with any of those numbers as I move along, I hope you'll interject and say so.

In last year's Economic Report that number of 138.3 million jobs predicted for 2004 was lowered to 135.2 million jobs. That was last year's Report.

In your most recent Report it has now been lowered to 132.7 million jobs.

And as I understand it, based on the lower job numbers for late 2003 and January 2004, you have now lowered the forecast even further to 131.9 million jobs for this year. Is that correct?

Dr. Mankiw. As far as I know. I can't verify each of those figures as I sit here. But you're absolutely right that the forecasts for jobs have been coming down.

Senator Sarbanes. So in just 2 years you've lowered the forecast for jobs for the year we're now in by 6.4 million. How do you explain that?

Dr. Mankiw. Well, I think two things. One is that the headwinds that this economy has been experiencing are stronger than all economists, both inside and outside Government, thought they were.

If you look at private sector forecasts for jobs, I think you would find a very similar picture to what you paint. So there's nothing unusual about Administration forecasts in what you're pointing out.

Secondly, there is this discrepancy between what the household survey and what the payroll survey is saying about the labor market. And as we discussed earlier, that's an outstanding puzzle that I don't think any economist fully understands at this point.

Senator Sarbanes. And you attribute this drop in the number of jobs forecast to that factor?

Dr. Mankiw. To the extent that the household survey is showing that more jobs have been created than the payroll survey does and that may explain—that may be part of the story as to why the payroll survey forecasts have turned out to be wrong.

Or to try to be more precise, we have two surveys of what's going on in the labor market. Those two surveys give you some significantly different job numbers over the past few years. We don't know where truth is. And very likely the truth is somewhere in between. And different economists can debate what the relative weights are they should give under these different surveys.

Senator Sarbanes. So which job numbers do you use when you make these predictions of total jobs?

Dr. Mankiw. Well, we look at both surveys and we actually do forecasts of both surveys. So if you look at the Report forecast table, you'll see a forecast of a payroll number. You'll also see a forecast of the unemployment rate. And the unemployment rate comes from the household survey.

So we look at both surveys. We try to forecast both surveys. For the most part, for the purposes of the forecast, it's for the purposes of budget planning, for the purposes of coming up with budget numbers. That's why this forecast is put to—

Senator Sarbanes. Which survey do you use in projecting these numbers that trail down now from 138.3 million just 2 years ago to where you are now predicting 131.9 million jobs? I mean, that's a drop of 6.4 million jobs. Which survey are you using?

Dr. Mankiw. Well, that particular forecast is a forecast of what the payroll survey will show. But we also look at and monitor and make forecasts of results from the household survey.

Senator Sarbanes. And what does that show you?

Dr. Mankiw. Well, you can see the unemployment rate—if you look at the same table on page 98 of the Report, you will see the forecast for the employment rate there.

We forecast a decline in the unemployment rate of 6 percent in 2003 to 5.6 percent in 2004. That we've already hit. This was made, as I said, in early December, even before a November number was known—

Senator Sarbanes. How many jobs go with that forecast?

Dr. Mankiw. I don't have that number with me, but we can get that to you.

Senator Sarbanes. All right. If you could do that, that would be helpful.

Senator Sarbanes. The International Monetary Fund not long ago said, and I'm now quoting from their Report on United States fiscal policies and priorities for long-run sustainability:

"Against the background of a record high United States current account deficit and a ballooning United States net foreign liability position the emergence of twin fiscal and current account deficits has given rise to renewed concern.

"The United States is on a course to increase its net external liabilities to around 40 percent of GDP within the next few years, an unprecedented level of external debt for a large industrial country. This trend is likely to continue to put pressure on the U.S. dollar, particularly because the current account deficit increasingly reflects low saving rather than high investment.

"Although the dollar's adjustment could occur gradually over an extended period, the possible global risks of a disorderly exchange rate adjustment, especially to financial markets, cannot be ignored. Episodes of rapid dollar adjustments failed to inflict significant damage in the past.

"But with United States net external debt at record levels, an abrupt weakening of investor sentiments vis-a-vis the dollar could possibly lead to adverse consequences both domestically and abroad."

How concerned are you about this?

Dr. Mankiw. The United States still remains one of the best places in the world to invest. The United States had one of the highest growth rates in the developed world last year. According to most forecasts it will have one of the highest growth rates in the developed world in 2004.

That high growth rate is the reason why investors around the world have found the United States a good place to put their money. And as Dr. Forbes said a moment ago, the flip side of that capital inflow is a current account deficit.

A variety of things. As we discussed in the last chapter of the Economic Report, there are a variety of ways in which the current account deficit will very likely over time move toward a balance. Higher growth abroad will tend to increase the demand for our exports. And that's one of the reasons why we should encourage other countries to pursue pro-growth policies.

In addition, higher saving in the United States would reduce our reliance on capital inflows from abroad to finance domestic investments. That's one of the reasons why it's important for the budget

deficit to shrink over time to reduce the drain on national saving from the budget deficit.

And in addition, it's one of the reasons why we need to encourage private saving. And that's why the President has put forward his lifetime savings account and retirement savings account initiatives in order to change the tax code in a way to make private saving more advantageous.

Of course, private savings is important beyond the current account deficit. But increasing private saving will tend to reduce the current account deficit over time.

Senator Sarbanes. Mr. Chairman, I see my time is up. If I could just close out.

I draw from that response that you are not very concerned, and I just want to add a quote from Chairman Greenspan on the United States current account deficit:

"There are limits to the accumulation of net claims against an economy that persistent current account deficits imply. The cost of servicing such claims adds to the current account deficit and under certain circumstances can be destabilizing."

You're the Chairman. I don't see much concern out of the Council. But I'm sure we'll address it again and again as the year goes on.

Chairman Bennett. I'm sure we will.

Senator Reed.

Senator Reed. Thank you very much, Mr. Chairman. And thank you, ladies and gentlemen.

In your Report you talk about the Social Security trust fund and point out that the 75-year actuarial deficit is the usual measure, but it might really underestimate the challenges. But 75 years is much longer than we estimate taxes or anything else.

So I'm just curious. What's the 75-year cost of making the tax cut permanent, Mr. Chairman?

Dr. Mankiw. I do not have that number in front of me. I'm sorry. We can try to find it for you.

Senator Reed. Would it be a larger number than the difference between Social Security revenues and benefits over 75 years?

Dr. Mankiw. I don't have the number. I can't compare it to anything.

Senator Reed. You don't even have sort of an instinctual, notational feeling about what the 75-year gap is between revenues and expenditures and how does that measure up with the tax cut?

Dr. Mankiw. I'm not sure it would be useful for me to guess on that.

Senator Reed. Does anybody back there have it?

[No response.]

Senator Reed. No, you don't just have that kind of number at your fingertips today. That's curious. I would think you would know the impact over many years of the tax cuts since you go to the point of saying how even a 75-year actuarial solvency rate for Social Security might underestimate the challenges.

Dr. Mankiw. I don't have that number, sir.

Senator Reed. But you'll get it to us?

Dr. Mankiw. We will try.

Senator Reed. I don't think it's that hard to calculate. Do you have a projection—how long are your projections for the tax cut?

Dr. Mankiw. I think the budget—those are numbers that would come out not of the Council of Economic Advisers, but come out of the U.S. Treasury and the Office of Management and Budget. So those are the institutions that we would go to to try to get the numbers. The budget that came out last week went out 5 years. But I don't—

Senator Reed. So as the Chief Economist to the President of the United States, who is recommending permanent extension of tax cuts—I guess “permanent” means at least 75 years—you have no idea how much that costs?

And you also don't know or have any idea of the difference between the revenues and the benefits of Social Security, which is one of the major costs mandated by law today. You don't even have a notion?

Dr. Mankiw. We have numbers on the Social Security imbalance in the Economic Report. I don't have those in my head. There's no question that there's a fundamental challenge in terms of putting Social Security on a sustainable basis. And that's something the President is very focused in on.

That's why he talked about it in the last campaign. That's why he appointed a commission to come up with different models for Social Security. And he looks forward to working with Congress to try to get that done.

Senator Reed. As I recall, one of the principles that the President enunciated when he was talking about Social Security surpluses is that it must be preserved only for Social Security.

Yet in the 10-year budget that we're looking at, that principle seems to be violated since Social Security funds will be used to effectively cover other expenditures of the Government.

Dr. Mankiw. All the money that's supposed to go into the Social Security trust fund is going into the Social Security trust fund. But that doesn't mean that we don't have a challenge. We do have a challenge.

The Social Security is, as the President has said many times, as the President's budget has said many times, as the Economic Report makes clear today, is in need of long-term reform and modernization to make it sustainable for future generations.

Senator Reed. I'm just amazed that you don't have even a rough estimate of the difference of these cost. That's what I find totally amazing from the chief adviser to the President on the economy. But let's move on.

If all the President's budget proposals are implemented, will the net effect be to increase or reduce the deficit over the next 5 years compared with what is projected in the OMB current services projection?

Dr. Mankiw. The President has said that he wants to make the tax cuts permanent. He believes that is important for economic growth. He believes it's important to make sure the recovery continues.

And other things equal, cutting taxes does tend to raise the budget deficit. That is why other things aren't equal. And that is why the President at the same time he's proposing making the tax

cuts permanent is also proposing spending restraint and proposing a budget that would reduce the budget deficit in half over the next 5 years through significant spending restraint.

Senator Reed. Well, what happens after those 5 years to the budget deficit?

Dr. Mankiw. As you look further ahead, the long-term pressures from the entitlement programs kick in. The President's budget from last year called that the real fiscal danger because we have these large unfunded liabilities.

And the budget deficit will tend to rise if these programs are not reformed and not modernized. That's why modernization of the entitlement programs is such an important priority.

Senator Reed. So 5 years—after 5 years the deficit increases given the President's current budget plan.

Dr. Mankiw. I don't have the year-by-year numbers, but going forward 10, 20, 30 years as the baby boomers retire, as the demographic transition hits us, absolutely. There are tremendous budgetary pressures coming from that.

Senator Reed. And I—

Dr. Mankiw. Everyone acknowledges that. The President's budget last year acknowledged that. The Economic Report of the President, if you look in the chapter on Social Security, acknowledges that.

Senator Reed. Has the President proposed changes to the entitlement programs of his budget to deal with those issues?

Dr. Mankiw. He's looking forward to working with Congress on that issue. He put together a Social Security Commission that came out with a variety of models for reform. We used one of those models as an illustration in this chapter here. But the President has not put forward a specific proposal. And that's something we look forward to working with the Congress on.

Senator Reed. Thank you.

Chairman Bennett. Thank you, Senator. I go back to my opening statement, where I said I don't know what the numbers will be, but I do know they will be wrong. And I have learned while I have been in Congress that the farther out you go, the wronger you are.

A 6-month forecast has a pretty good chance of being fairly close. A 1-year forecast, as we've seen last year, missed by \$80 billion. A 5-year forecast, I guarantee you, is going to miss it by more than that.

No matter how many brilliant Ph.D.s, MBAs, CPAs you gather in a room to come up with it, no matter how you program the computer, a 75-year projection—I appreciate that you will be responsive to Senator Reed and I have every respect for Senator Reed—but a 75-year projection of the economic number relating to tax cuts is useless. I'm sorry. I guarantee you the number will be useless.

The only reason that we can be sure or we can have a fairly good idea of what will happen with Social Security is that we're dealing with demographics as opposed to dealing with the ebbs and flows of the economy.

So make your calculation, but for the record I don't put any stock in how valuable that number would be in coming to any kind of policy decision.

Let's go back, Dr. Forbes, to the international economy for just a minute. Senator Sarbanes raised the issue from the International Monetary Fund about where we stand.

I have never been a fan of the IMF in terms of their prescriptions as to what economies ought to do. I spent some time dealing with the Russians, who were trying to follow IMF restrictions. And they were talking about shock therapy. And if I may, the language that came from the Russian ambassador—he said, “We've had plenty of shock and damned little therapy.”

And the Chinese told the IMF basically to take a hike and built their economy the way they wanted instead of the way the IMF was instructing them and did substantially better.

Where are we compared to other developing economies? The things we've been talking about here. Is our unemployment rate higher or lower? Is our deficit as a percentage of GDP higher or lower? Is our level of economic growth higher or lower than other countries?

Can they give us a benchmark as to how well American policies are doing as we look around the world at some of the other countries that are trying to give us instructions as to what we should be doing?

Dr. Forbes. That's an excellent question. And it actually highlights the strength of the United States economy by answering the different points you raised.

Starting with the deficits, the deficit in the United States economy right now is higher than in Europe although several of the large European countries have seen a significant increase in their deficits and are quickly approaching the deficit of the United States.

Chairman Bennett. Let me just take debt as a percentage of GDP because deficit is a year-by-year thing. Debt is the accumulation of long-term activity. What is our debt percentage of GDP—

Dr. Forbes. Our debt to GDP I believe is slightly lower than in, say, France and Germany, the largest economies in Europe, and substantially lower than in Japan, which is the second largest economy in the world. Actually Japan not only has a much higher debt level, but also a higher deficit on an annual basis.

So compared to other countries in terms of deficits and debt, the United States is sort of in the middle.

According to most other indicators, though, the United States is much stronger than the other developed economies in the world.

Growth in the United States next year is expected to be double in the United States what it will be in Japan or Europe. Growth in Japan and Europe next year is expected to be an improvement over recent years and considered strong. But it's still only about half of what is expected in the United States.

On unemployment the United States also does well on a cross-country basis. Although unemployment is still much higher than we would like to see in the United States, it's still substantially lower than in Europe and a bit lower than in Japan.

So according to those standard economic indicators, even though we'd like to see a faster recovery in the United States and more improvement in the labor market, the United States does quite well on a cross-country basis.

Chairman Bennett. What would happen if the other countries in the world became more robust in their economic growth? How would that affect us?

Dr. Forbes. We would be delighted if growth picked up in other countries in the world. This is actually something the Government has been working on actively through the agenda for growth, encouraging other countries to adopt reforms to improve growth.

If other countries grew faster, they would export more from the United States. That would mean United States exports to—

Chairman Bennett. They would import. We would export.

Dr. Forbes. Import more from the United States. Thank you. We would export more. And that should help reduce the United States current account deficit.

Actually in the past 3 years, since about 2000, most of the increase in the United States current account deficit is because of a contraction in exports largely to other large economies in the world because growth has been so slow in Europe and Japan.

So if growth picked up in other countries, that would directly help the United States economy.

Chairman Bennett. So this is an oversimplification, but basically if the other countries in the world were able to follow our economic performance, not only would they be better off, but we would be substantially better off as well.

Dr. Forbes. The global economy would benefit from faster growth in all the major economies in the world.

Chairman Bennett. So maybe we're not doing as badly as some of the questions here today might suggest.

Mrs. Maloney.

Representative Maloney. Thank you so much, Senator Bennett.

As someone who has supported some trade agreements, I am astonished by the Administration's insensitivity to outsourcing. Your Report seems to cheerlead the outsourcing while your budget cuts adult training programs and worker relocation.

I certainly understand how trade can be disruptive to some communities and some people. But I don't see anything in these headlines that were in the papers yesterday about the Administration's plans for workers who have just lost their jobs.

Does the CEA have any estimates of the number of jobs lost because of outsourcing? In other words, how many people are likely to experience disruption from this development?

Dr. Mankiw. We don't have any official number. We've looked at some of the private sector numbers on this. The numbers tend to be small, but they are growing.

And we live very much in a changing world, where things that were once non-tradable goods are suddenly tradable goods. We're very used to goods being produced abroad and being sent here on ships and planes.

What's new about the world is we're now seeing some services produced abroad and being sent here over fiber optic cables.

But the economics are not fundamentally different in the two cases. The key question is whether we want to erect barriers around our Nation and retreat from the principles of free and open trade or whether we want to embrace a free and open world trading system and enjoy the benefits of trade and get workers into jobs in which the United States has a comparative advantage.

The President is very focused on putting people back to work and creating jobs. We don't believe that erecting barriers to trade is the way to do that. We believe the way to do that is to promote economic growth. And the President has put policies in place to do that.

We believe it's important to train workers. The President has pushed hard to improve our community colleges, for example, and believes that community colleges are very important mechanisms and institutions to help workers make a transition from the declining to the growing parts of the economy.

Representative Maloney. Well, my question was not about trade as much as what is the impact having on American jobs? And since you do not have any numbers, but I would say that most private firms and others see an increase in unemployment in the short run and possibly in the long run too.

And I would like to know what is the Administration planning to do to help these workers who are unable to find work as a result of this outsourcing. And my understanding is that the President's budget cuts adult training and dislocated workers assistance by \$151 million or roughly 4.8 percent.

How do you justify that and the fact that the Administration canceled an extension of temporary unemployment benefits even though we still have a huge job deficit and a record number of unemployed workers exhausting their regular benefits without qualifying for any additional assistance?

It is a phenomenon that's here. What are we doing about it? Many people are out of work. Hopefully we'd like to create more jobs, but there have been forecasts. We have not met that forecast. We have a well over 2.2 million job loss and yet they're cutting workers' assistance.

Dr. Mankiw. Well, as we talked earlier, there is some discrepancy in the statistics about exactly what the labor market looks like today. But it's certainly not as strong as we'd like. We believe we have policies in place to make it stronger.

The job market has been getting stronger. The unemployment rate is down from 6.3 down to 5.6. That is a very significant improvement. Our forecast and private sector forecasts as well suggest continuing improvement in the months to come.

On the issue of training, the President has a variety of proposals. He's talked recently about community colleges. He has a proposal for personal re-employment accounts in order to help workers make a transition to new jobs.

Representative Maloney. Well, why shouldn't we extend unemployment?

Dr. Mankiw. The President has worked with Congress in the past to extend unemployment benefits. The President will continue to work with Congress on that issue. The key is to get people back

to work. That's the most important priority and I think we can agree on that.

Representative Maloney. Part of helping our economy I would think would be reducing the deficit. But isn't the President's focusing on cutting the budget deficit in half over the next 5 years misleading? It conveys the impression that you'll keep reducing the deficit after that, doesn't it? And that's not true when you look the—on page 192—not in your book, but in the analytical perspectives, it shows quite a deficit coming if we don't change our policies.

Unfortunately there are no budget tables for the fiscal years 2010 and 2014 that show the impact of making the tax cuts permanent. Won't all of the costs of these tax cuts have to be financed by additional borrowing, which means the deficit will be made larger by the tax cuts.

I find this very troubling. The first set of tax cuts we had a surplus. The second time we had a deficit. To make them permanent we are really borrowing from our grandchildren—if I should be so fortunate to have them.

And one of the points that Dr. Forbes said that I found disturbing, she talked about the fact that we are borrowing so much from foreign countries. And I remember in 1992 before we started getting the economy moving, there wasn't any money in the economy. All of this was going to pay for the debt.

I don't see how we can make our economy grow if we continue to grow the deficit, borrow from foreign countries. One answer was that foreign countries are investing in America. But are they going to continue to invest in America if we continue to grow our deficit?

It is galloping forward—not in your charts. Yours are only good for 5 years. But in the charts here is it galloping forward.

That is a tremendous burden to put on future generations for permanent tax cuts. We're going to cut taxes and borrow money. We're cutting taxes to borrow money from foreign countries.

Dr. Mankiw. The deficit is unwelcome. It is undesirable. But it's also understandable in light of the contractionary shocks that—

Representative Maloney. And it is growing. And the tax cut is adding to it, right?

Dr. Mankiw. It is understandable in light of the contractionary shocks that the economy has experienced. We want it to shrink. The President has put forward a budget in which it will shrink.

And the fundamental disagreement seems to be over how—not whether the deficit should shrink—but how that's going to be accomplished.

Some people think the deficit should be reduced through higher taxes. The President has made clear that his priority is not to raise taxes on the American people but to reduce budget deficits through spending restraint.

Long term—which I think is the forecast that you were looking at—long term the issue of budgetary pressure comes from the entitlement programs. As we spoke about a few minutes ago, a reform and modernization of those programs is crucial. The need for modernization of those entitlement programs is true today and it was true 3 years ago when we had budget surpluses. That long-term fiscal challenge has not fundamentally changed in the past 3 years.

Representative Maloney. The President's forecasts on jobs, the number of jobs lost, the escalating deficits, the forecasts of this Administration on the budget speaks for itself. My time is up.

Chairman Bennett. Before I recognize Mr. Paul, just for the sake of the record in this discussion, when we're talking about letting unemployment—extensions of unemployment compensation expire, we've always extended unemployment compensations during recessionary times. We've always let them expire when we think the economy has started to grow.

The last time the unemployment compensation was allowed to expire during the Clinton Administration unemployment at the time, those benefits were allowed to—the extended benefits—were allowed to expire, unemployment was at 6.6 percent. In this Administration it was at 5.6 percent.

Mr. Paul.

Representative Paul. Thank you, Mr. Chairman.

I would like to just start off by reminding the Committee that possibly someday we should not refer to tax cuts as a cost of Government. That to me indicates the Government owns everything. And there's a cost to Government it's to give people back what they've earned. That I don't like.

But I want to get back with Dr. Forbes on this current account deficit. Believing that all current account deficits aren't the same, I don't very often agree with Alan Greenspan, but I think he's expressed the concern about the current account deficit.

I really think the fact that—many economists have expressed concern about the deficit. Those who have been concerned and don't say, well, they're investing growth in America and it's all positive, the fact that the dollar is going down confirms that those of us who are concerned see it out of balance and this should be something we should be concerned about.

My point about the difference between two current account deficits is that yes, in the past we have had deficits, but conditions were different. Certainly in the 19th Century they were investing in America. We were an industrial country building and booming. And they were loaning and there were no devaluations. Currencies were more universally accepted. And it wasn't a problem.

Today I think it's a mistake to assume this is the same principle and they're investing in America's growth and it's positive. I think they do it out of desperation.

The other countries—you're right. We're better than they are. So just because we're a little bit better shouldn't be too much reassurance to us that, oh, they're going to send these dollars back.

I still believe what is happening because the reserve currency of the world, we have rampant monetary inflation that we get a free ride. We export our dollars. We buy cheap goods. Our consumers benefit. And then the Japanese and the Chinese end up with dollars and they want to artificially keep their currencies high.

So they are more than willing, and I think in the long run, mistakenly they send those dollars back to buy Fannie Mae and Freddie Mac and Treasury bills. It is a gift to us. It's wonderful. But, boy, I don't believe for a minute it's because of the strength of America.

The question is, don't you ever see that there could be a difference between two account deficits and that one when it's loaned back to us for consumption is quite a bit different than sending it in here to build steel plants and build railroads?

Dr. Forbes. I think you are correct in stating that every current account deficit is different. And you do need to look at all the economic forces causing that current account deficit.

A current account deficit is equal to the difference between savings and investment in a country, so a part of the reason for the United States current account deficit is low savings—both the Government savings and private savings in the United States.

But part of it also is high investment, that investment is higher than savings, so we are borrowing from abroad to fund this investment higher than what we can fund domestically.

Again, as I said earlier, part of the reason for the current account deficit is that foreigners do see the strength and the potential of the United States economy. That's why they are willing to help fund investment and fund the current account deficits.

Also, just to draw on what Chairman Mankiw said earlier, we do expect the current account deficit to decrease in the future. And even the last trade numbers do suggest a small shrinking in the United States current account deficit.

So it is perfectly reasonable that the current account deficit does shrink over time. But there's no reason to necessarily expect that this will be a difficult adjustment or anything to be concerned about.

In the mid-1990s there was a large current account deficit—not quite as large as today, but still a large deficit—and it did shrink gradually without being very painful to the United States economy. And it's perfectly reasonable that we could see the same situation in the United States in the future.

Representative Paul. On one other subject, possibly for the Chairman, Chairman Bennett mentioned that the projections are always wrong. And I think everybody recognizes it is very difficult to make projections. But revenue projections especially are always wrong because economies change quickly.

But why don't we emphasize more on the spending side? Why do we give up so easily? I mean, the Administration has made no effort—no vetoes, no effort—to cut anything. They just say, well, we have to do everything.

So whether it's going to the moon or welfare spending or education or department of energy or department of homeland security or invading another country, there's absolutely no restraint on spending.

So I don't see how we can possibly—I mean, if we're out of balance it's dangerous. How can we possibly get it back in order if we, the conservatives who are in office now, can't do a better job on cutting some spending?

Dr. Mankiw. It's the President's job to set priorities. He's made it very clear many times that his first priority is defending the Nation, protecting the homeland, and that's why spending on those very important categories in the budget has gone up.

But he also has made it clear that spending restraint is a very important part of the economic plan. And that's how he wants to get the budget deficit reduced over the next 5 years.

The budget he put forward this last week showed non-defense, non-homeland security spending going up by less than 1 percent. In real terms that means non-defense, non-homeland security spending will be actually falling. That is significant spending restraint.

And he's going to be working with Members of Congress to get that significantly fiscally conservative budget passed. One of the first things he'll be working with Congress on is the highway bill. It's going to be very important, as that highway bill works its way through Congress, to show our Nation's commitment to restraining spending.

Chairman Bennett. I don't think we need another round, but Mrs. Maloney does have one more question she would like to ask. Then I will close it out.

Representative Maloney. I would just like to place on the record this statement on employment to really factually put it on the record.

Representative Maloney. But I would like to ask Chairman Mankiw, does every dollar of making the tax cuts permanent have to be borrowed in the 2010-to-2014 year period? Yes or no?

Dr. Mankiw. Part of the reason for making the tax cuts permanent is to stimulate economic growth and part of the cost of the tax cuts will come back in the form of higher economic growth.

There's a chapter in the Economic Report of the President on dynamic budget estimations—sometimes they refer to it as dynamic scoring—of tax changes. And so part of any tax cut will be recouped, but probably not all of it.

And other things equal, it would be borrowed. That's why spending restraint is a policy that goes hand in hand.

The way I think about it is, the Government faces a budget constraint. The only way to make tax cuts permanent is to restrain spending. So permanent tax cuts and spending restraint are policies that have to go hand in hand because the Government faces the budget constraint. You can't cut taxes unless you also restrain spending. And that's why the President has put forward this budget.

Representative Maloney. Well, I'm conservative to the extent that I don't believe in dynamic scoring. I believe in what are the facts that are before you, not what you project in the future. That's another argument.

My question is—and it has nothing to do with dynamic scoring—my question is does every dollar of making the tax cuts permanent have to be borrowed in the 2010 to 2014 period? That's the question, not what's going to happen in the future, but does every dollar of making the tax cuts permanent have to be borrowed?

And we hear from Dr. Forbes when we borrow, we're borrowing from abroad. So does that have to be borrowed in the period from 2010 to 2014?

Dr. Mankiw. No, it doesn't have to be borrowed. You can restrain spending in response to those tax cuts.

Representative Maloney. But if we have the budget that we have now going forward. You're talking about restraining spending. You don't know what the expenses are going to be. A budget was presented to us that literally left out the war in Iraq, left out the war in Afghanistan, left out the Social Security projected changes.

So basically if we move forward, based on my studies we're going to have to borrow that money from a foreign country we hear from Dr. Forbes.

Dr. Mankiw. If you assume that you can't restrain spending and you're going to cut taxes, then you're going to borrow the money, but that's not the policy.

The policy is—and in fact, you can't cut taxes permanently unless you're going to restrain spending because the Government has to pay its bills. So spending restraint and making the tax cuts permanent go hand in hand as policies.

Chairman Bennett. Thank you very much for being here. This was a little heated conversation, but this is an election year. And I think heated conversations in election years are inevitable.

My answer to Mrs. Maloney's question would be "who knows?" I would note for the record, the historic record, that we have had marginal tax rates as high as 92 percent in this country. And we ran huge deficits at the time.

President Kennedy startled everybody when he said we should have a tax cut to bring the marginal rate down to 70 percent. And there were conservatives, Mr. Paul, in that Congress who voted against it on the grounds that we couldn't afford it, that the deficit was so high that we couldn't afford to cut the tax rate from 92 percent to 70.

And then I remember when the Congress decided that taking more than half of somebody's money was somehow immoral. And we cut the top marginal rate to 50 percent.

Under the prodding of Ronald Reagan we cut the top marginal rate to 28 percent. Now, it is 36 percent and coming down as the President's tax cuts phase in.

The interesting thing is that the revenue-to-Government measured as a percentage of GDP stayed about the same in that whole period. The revenue-to-Government since the end of the Second World War has been in a band of about—around 17 to 18 percent of GDP. Sometimes it's been higher. In the Clinton years it got as high as 21 percent of GDP.

And why was that? Because the actual revenue that came in when we, the Congress, cut the tax rate for capital gains was 5 times the projected revenue that would come.

You say you don't like dynamic scoring. But the static scoring projected that a cut in the capital gains tax rate would mean a cut in the capital gains tax realization. And in fact, cutting the capital gains tax rate caused people to start to make deals that they wouldn't have made before because their money was locked in with the higher tax rate. They sold, got the capital gain, paid the tax, and tax realizations were 5 times what the computers at CBO told us they were going to be.

That's where we got our surplus. The surplus came out of that tremendous river of cash that came out of a combination of a strong economy and tax cuts.

Then in California and many other States the State legislatures made the terrible decision of assuming that that was permanent and that that river of cash would continue to come.

And they built in structural spending into their projections on the assumption that the economy would still give them the cash that had come in before. And suddenly they were faced with the kind of deficit that ultimately drove the governor from office.

I've come back to the theme that I made in my opening statement. The economy is fluid. You cannot make projections 5 years, 75 years in advance and have any confidence whatsoever that those will come to pass in terms of economic projections.

The one thing we can be fairly sure of is that the tax realizations in the economy will hover somewhere in the band between 18 and 20 percent of GDP. That has been stable from the end of the Second World War until now whether the top tax rate was 70 percent or 50 percent or 28 percent or 38 percent.

All we do as we jiggle these tax rates, which we call tax cuts and tax increases, is change the distribution of where we collect the taxes and try to become as efficient as possible in getting the tax revenue from the Government.

In other words, if we're going to be in that band of 18 to 20 percent of GDP, we want to do it in a way that damages the economy the least. And if we can do it in a way that makes the economy as efficient as possible, then the economy grows. And 18 percent of the much larger figure is in itself a much larger number.

Chairman Mankiw, you have emphasized once again the most significant point. And Alan Greenspan has made this point also to us a number of times. He says that Congress can set the level of spending just about anywhere it wants. You can pass a law that says we're going to spend X, Y, or Z and you can spend X, Y, or Z. The thing you cannot set is the level of revenue, because the level of revenue is a function of how well the economy is doing.

And if you make the mistake that was made in the 1990s of assuming that that level of revenue is going to be permanent, we would never have a recession, the dot-com bubble was never going to burst, the stock market irrational exuberance was never going to have a correction. We were never going to have a war. Everything was going to keep going.

And we set spending levels on those assumptions. We paid for it. We have a war. We have a recession. The bubble burst. And the level of spending that we set in the 1990s is unsustainable now without a deficit, without borrowing.

The main lesson that I think we all need to learn—and frankly as Chairman of the Committee, if I can say should be a motto for the Committee—is that all of us in public life need to be a whole lot more humble about our ability to control these events.

And we should adopt our policies with the understanding that the economy determines how much money we get. We don't. The tax laws don't determine how much money we get. The budget doesn't determine how much money we get. The economy determines how much money we get.

And our responsibility on this Committee and you as you advise the President should be to come up with a policy to make the econ-

omy as efficient as possible, as strong as possible, grow as rapidly as possible.

And then we can argue about how to spend the money that that economy at about 18 to 19, at top 20, percent of GDP will return to us regardless of how we jigger and restructure the tax code.

And with that I think you for your indulgence. The hearing is adjourned.

[Whereupon, at 4:05 p.m., the hearing was adjourned.]

Submissions for the Record

PREPARED STATEMENT OF HON. ROBERT F. BENNETT, CHAIRMAN,
A U.S. SENATOR FROM UTAH

Good afternoon and welcome to today's hearing on the *Economic Report of the President*. Congress created the Joint Economic Committee and the President's Council of Economic Advisers in 1946 and mandated that the Council issue an Economic Report each year and officially present it to this Committee. In today's hearing we will have the opportunity to hear directly from its authors what is included in this year's report and to discuss with them the economic issues that face us today.

The last few years have dealt us a series of blows. An already weakening economy was hit by terrorism, corporate scandals, and increased requirements for homeland security and defense. But, despite this "perfect storm," recent economic indicators tell us what many have already been feeling, that the economy is now experiencing a strong recovery.

2003 ended with very strong growth, averaging 6.1 percent in the second half, the fastest growth in consecutive quarters since 1984. The unemployment rate continues to fall, manufacturing activity is increasing, and stock prices continue to rally. Over the next year, we can look forward to a robust economy and the job creation that will follow. What we must begin to focus on is where we will be 10 years from now and beyond.

Recent budget projections have spurred a lot of discussion about the deficit. Let's preface this discussion by acknowledging that budget forecasts are an educated guess, at best. Historically, we haven't always known if the projected numbers are too low or too high, but we know they are not the gospel truth. The uncertainty in our economy inevitably invalidates even the best-crafted projections.

In the near term, the deficit is large, but manageable. Deficits should be measured relative to the size of the economy to account for the economy's capacity to absorb them and the Government's ability to finance them. When measured as a percentage of GDP, today's deficits are still below the peaks of the 1980s and 1990s.

However, continued increases in the deficit could pose significant economic problems if they persist. We must therefore turn our attention to Federal spending, whose recent growth rates are clearly unsustainable. We need to slow the growth of discretionary spending, for sure, but it is less than half of the equation. The bigger problem we face in the long run is rapidly escalating entitlement spending. According to the President's budget, entitlement spending is on track to increase from 10 percent of GDP to more than 20 percent in coming decades. Long-run fiscal discipline demands that we consider serious reforms before this massive spending growth comes to pass.

One particular problem that we must address is the enormous burden that will be placed on the economy once the baby boomers begin to retire toward the end of the decade. As these men and women retire, the Nation faces a serious challenge with fewer workers available to support each retiree. We will see increasing pressure on Social Security and Medicare. In order to manage this change, we will need to undertake serious reforms of these programs.

Some commentators have suggested that one step in returning to fiscal discipline would be to allow the President's tax relief to expire in the years ahead. This is short-sighted. Rescinding the tax relief would do little to improve the long-run fiscal situation of our Government, but would weaken our economy today. The tax cuts had an immediate beneficial effect on the economy and contain important elements that will encourage work, saving, and investment and keep the economy growing for years to come. We must not short circuit these powerful incentives by failing to maintain them in law. Moreover, people need to be able to plan for their financial

future and they cannot do so if they don't know what tax laws will be from one year to the next.

We welcome the members of the Council of Economic Advisors to Congress today. Dr. Greg Mankiw, Chairman of the Council, and Drs. Harvey Rosen and Kristin Forbes, we have enjoyed working with you and your team and we look forward to continued cooperation between the CEA and our Committee. The other Members of the Committee and I are anxious to hear your thoughts about the current state of the economy, and the various proposals and policy reforms presented in the *Economic Report of the President*.

PREPARED STATEMENT HON. CAROLYN B. MALONEY, A U.S. REPRESENTATIVE
FROM NEW YORK

Thank you, Chairman Bennett. I also want to thank you for holding this hearing, which continues a JEC tradition of having the Council of Economic Advisors present and discuss the Economic Report of the President. I want to welcome Dr. Mankiw, as well as Drs. Forbes and Rosen.

This is a big report with a slick cover and a lot of chapters. But there seems to be an important chapter missing—the chapter that explains why it's good economic policy to lose over 2 million jobs and to completely squander the climate of fiscal discipline that President Bush inherited. As the *New York Times* recently noted, Republicans have become a band of "budget buccaneers" lacking any fiscal integrity.

The President makes the hollow promise to cut the budget deficit in half in 5 years, but the Administration clearly has no serious plan to address the deficit, which is projected to be \$521 billion in 2004. While it is true that both the Administration and the Congressional Budget Office estimate that the deficit will fall as a share of GDP over the next 5 years with no new policy changes, long-range projections show that this is a temporary improvement and budget deficits will explode with the retirement of the baby boom generation. The Administration's proposed policies make the 5-year deficit worse than it would be with no policy changes. Moreover, making all of the President's tax cuts permanent will seriously worsen deficits beyond 2009. This is hardly a picture of fiscal discipline.

The Administration's budget submitted last week really should be graded incomplete for omitting many likely policy changes and presidential policies that will make the deficit even worse. For example, it leaves out funding for Iraq and Afghanistan, the costs of fixing the Alternative Minimum Tax, and the true costs of the President's vision to send humans to Mars and privatize Social Security. And while the Bush budget continues to include large and unaffordable tax cuts, the Administration's unwillingness to provide budget figures beyond 2009 hides the true costs of those tax cuts.

The Administration continues to argue that our Nation's fiscal deterioration is due almost entirely to events beyond its control—mainly the economic recession and executing the war on terrorism. But the facts are that the tax cuts already passed are responsible for a third of the deterioration in the budget outlook for 2004 and 2005. If the tax cuts were to be made permanent, this share would only increase over time.

Dr. Mankiw is on record in his textbook and academic research as arguing that persistent large budget deficits are harmful to the economy. I would be interested in knowing what advice you've given the President with respect to these ballooning deficits.

There's another deficit that I'm concerned about—the jobs deficit that President Bush has presided over. A year ago, the Administration estimated that nearly 2 million jobs would be added in the second half of 2003—510,000 of them due to the President's tax cuts. In fact, less than 200,000 jobs were created during that period. To its credit, the Economic Report of the President acknowledges that job performance has been disappointing. On page 48, the Report says, "Indeed the performance of employment over the past couple of years has been appreciably weaker than in past business cycles . . . [It] has lagged even that of the so-called 'jobless recovery' from the 1990-91 recession."

Indeed, President Bush is on track to be the first President since Herbert Hoover to end his term with fewer jobs than when he started. We've been gaining jobs slowly since August, but at the pace we've seen so far, it would take nearly 2½ years to erase the current jobs deficit. President Bush would end his term in January 2005 with a deficit of nearly 1½ million jobs. Job creation would have to average 186,000 jobs per month from February 2004 to January 2005 just to erase the current 2.2 million Bush jobs deficit completely. We're a long way from that and even farther away from full employment.

References to foreign outsourcing in the ERP and Dr. Mankiw's comments on the topic have not been well received here on Capitol Hill. We need to know how much the President's tax and trade policies have contributed job losses over the last 3 years. We also need to see this Administration demonstrate more compassion to the workers who have been hurt by this trend.

House Democrats last week forced the passage of legislation that would restore temporary Federal unemployment insurance benefits that President Bush and the Republican-controlled Congress allowed to expire at Christmas. Following the 1990-91 recession, the Administration of President Bush's father provided 20 weeks of temporary Federal UI benefits in all States until 1.6 million jobs had been created. While the President has pledged to extend his tax cuts, he has no plans to extend jobless benefits for the long-term unemployed. This is hardly a picture of compassionate conservatism.

In short, this year's Economic Report of the President ignores the biggest issues before us—the jobs deficit and the budget deficit.

I look forward to Dr. Mankiw and his colleagues' testimony, and I hope you address the concerns I've raised.

PREPARED JOINT STATEMENT OF DR. N. GREGORY MANKIW, CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS; DR. KRISTIN J. FORBES, AND DR. HARVEY S. ROSEN, MEMBERS OF THE COUNCIL OF ECONOMIC ADVISERS

Chairman Bennett, Ranking Member Stark, and Members of the Committee, thank you for the opportunity to discuss the release of the *Economic Report of the President* and the current challenges facing economic policy. The Economic Report released today covers a wide range of issues, including recent business cycle developments, tax policy, the health system, regulation, and the role of the United States in the world economy.

The U.S. economy made notable progress in 2003, propelled forward by pro-growth policies that led to a marked strengthening of activity in the second half of the year and put the United States on a path for higher sustained output growth in the years to come.

The recovery was still tenuous coming into 2003, as continued fallout from powerful contractionary forces—the capital overhang, corporate scandals, and uncertainty about future economic and geopolitical conditions—was offset by stimulus from expansionary monetary policy and the Administration's 2001 tax cut and 2002 fiscal package. The contractionary forces dissipated over the course of 2003, and the expansionary forces were augmented by the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) that was signed into law at the end of May.

The economy appears to have moved into a full-fledged recovery, with real gross domestic product (GDP) expanding 4.3 percent over the four quarters of 2003, significantly above the average growth rate since 1960 of 3.3 percent. This growth was particularly strong in the second half of the year, after the passage of the Jobs and Growth tax relief bill. The last two quarters of 2003 showed the most rapid growth of any half-year period in nearly 20 years. The labor market is also starting to improve. Payroll employment reached a trough in August, and the economy has since created 366,000 jobs. The unemployment rate has fallen from a peak of 6.3 percent to 5.6 percent.

This *Report* discusses this turning of the macroeconomic tide, along with a number of other economic policy issues of continuing importance. The 14 chapters of this *Report* cover five broad topics: macroeconomic policy, fiscal policy, regulation, reforms of the health care and tort systems, and issues in international trade and finance. In all of these areas, the *Report* highlights how economics can inform the design of public policy and discusses Administration policies.

The Administration's pro-growth tax policy, in concert with the dynamism of the U.S. free-market economy, has laid the groundwork for sustainable rapid growth in the years ahead. Well-timed fiscal stimulus combined with expansionary monetary policy to offset and eventually reverse the contractionary forces impacting the economy. But there is still much to be done. The tax cuts must be made permanent to have their full beneficial impact on the economy. A stronger economy will also result from progress on the other aspects of the Administration's economic agenda, including making health care more affordable; reducing the burden of lawsuits on the economy; ensuring an affordable and reliable energy supply; streamlining regulations; and opening markets to international trade. These initiatives are discussed in this *Economic Report of the President*.

Chapter 1, *Lessons from the Recent Business Cycle*, discusses the distinctive features of the recent recession and subsequent recovery, and draws five key lessons for the future. The recent business cycle was unusual in that it was characterized by especially weak business investment but robust consumption and housing investment. This makes clear the first lesson, that structural imbalances such as the “capital overhang” that developed in the late 1990s can take some time to resolve. A number of events contributed to a climate of uncertainty in 2003, including the terrorist attacks of September 11, 2001, corporate governance and accounting scandals, and geopolitical tensions surrounding the war with Iraq. The second lesson from the recent business cycle is that the effects of the uncertainty from these events on household and business confidence can have important effects on asset prices, household spending, and investment. Resolution of some of the uncertainties appears to have contributed to the resurgence of growth.

Monetary and fiscal policies played a critical role in moving the economy back toward potential. Third lesson is that aggressive monetary policy can help make a recession shorter and milder. The fourth lesson is that tax cuts can likewise boost economic activity. Tax cuts raise after-tax income, while at the same time promoting long-term growth by enhancing incentives to work, save, and invest. Tax relief enacted in 2001 and 2002 helped lessen the severity of the recession, while the 2003 tax cut appears to have propelled the economy forward into a strong recovery. Job creation has lagged behind, even as demand has surged. Thus, the fifth lesson of the recent recession is that strong productivity growth, as was experienced in 2003, means that much faster economic growth is needed to raise employment. This productivity growth, however, is not to be lamented, since it ultimately leads to higher standards of living for both workers and business owners.

Chapter 2, *The Manufacturing Sector*, examines recent developments and long-term trends in manufacturing and considers policy responses. Manufacturing was affected by the economic slowdown earlier, longer, and harder than other sectors of the economy and manufacturing employment losses have only recently begun to abate. The severity of the recent slowdown in manufacturing was largely due to prolonged weakness in business investment and exports, both of which are heavily tied to manufacturing.

Over the past several decades, the manufacturing sector has experienced substantial output growth, even while manufacturing employment has declined as a share of total employment. The manufacturing employment decline over the past half-century primarily reflects striking gains in productivity and increasing consumer demand for services compared to manufactured goods. International trade has played a relatively small role by comparison. Consumers and businesses generally benefit from the lower prices made possible by increased manufacturing productivity, and strong productivity growth has led to real compensation growth for workers. While the shift of jobs from manufacturing to services has caused dislocation, it has not resulted, on balance, in a shift from “good jobs” to “bad jobs.” The best policy response to recent developments in manufacturing is to focus on stimulating the overall economy and easing restrictions that impede manufacturing growth. This Administration has actively pursued such measures.

Chapter 3, *The Year in Review and the Years Ahead*, reviews macroeconomic developments in 2003 and discusses the Administration forecast for 2004 through 2009. Real GDP growth picked up appreciably in 2003, with growth in consumer spending, residential investment, and, particularly, business equipment and software investment increasing noticeably in the second half of the year. The labor market began to rebound in the latter part of 2003. Inflation remained well in check, with core consumer inflation declining by the end of the year to its lowest level in decades. The improvement in the economy over the course of the year stemmed largely from faster growth in household consumption, extraordinary gains in residential investment, and a sharp acceleration of investment in equipment and software by businesses. Payroll employment bottomed out in August and rose 254,000 over the remainder of the year and a further 112,000 in January. Financial markets responded favorably to the strengthening of the economy, with the total value of the stock market rising more than \$3 trillion, or 31 percent, over the course of 2003.

The Administration expects the economic recovery to strengthen further in 2004, with real GDP growth running well above its historical average and the unemployment rate falling. Boosted by pro-growth policies and expansionary monetary policy, and on the foundation of the underlying strength of the free-market society in the United States, the economy is expected to continue on a path of strong, sustainable growth.

Chapter 4, *Tax Incidence: Who Bears the Tax Burden?*, discusses the analysis of how the burden of a tax is distributed among taxpayers. This question is important to policy makers, who want to know whether the distribution of the tax burden (between rich and poor, capital and labor, consumers and producers, and so on) meets their criteria for fairness. The key result is that the economic incidence of a tax may have little to do with the legal specification of its incidence. Rather, it depends on the actions of market participants in response to the imposition of the tax.

Distributional tables showing the tax burdens borne by different income groups are an important application of incidence analysis. When used properly, distributional tables can contribute to informed decision making on the part of citizens and policy makers. Unfortunately, mainstream economic analysis suggests that these tables do not always accurately describe who bears the burden of certain taxes. This problem does not arise from bias or lack of economic knowledge on the part of the economists who prepare these tables. Instead, it reflects resource and data limitations, uncertainty about some of the economic effects of taxes, and variations in the time frame considered by the analyses. Nevertheless, the shortcomings of distributional tables can lead to misperceptions of the impact of tax changes.

An important implication of the economic analysis of incidence is that, in the long run, a large part of the burden of capital taxes is likely to be shifted to workers through a reduction in wages. Analyses that fail to recognize this shift can be misleading, suggesting that lower income groups bear an unrealistically small share of the burden of such taxes and an unrealistically small share of the gain when capital income taxes are lowered.

Chapter 5, *Dynamic Revenue and Budget Estimation*, examines how taxes affect the behavior of firms, workers, and investors and discusses the implications for the estimated effects of a tax change on revenue. Changes in taxes and spending generally alter incentives for work, investment, and other productive activity—a higher tax on an activity tends to discourage that activity. Revenue estimation is called dynamic if it incorporates the behavioral responses to tax changes and static if it does not incorporate these behavioral responses.

To make informed decisions about a policy change, policy makers should be aware of all aspects of its budgetary implications. Currently, official revenue estimates of proposed tax changes incorporate the revenue effects of many microeconomic behavioral responses. However, these estimates are not fully dynamic because they exclude the effects of macroeconomic behavioral responses. Several obstacles have prevented macroeconomic behavioral responses from being incorporated in such estimates. This chapter discusses the ongoing efforts to provide a greater role for fully dynamic revenue and budget estimation in the analysis of major tax and spending proposals. At least in the near term, it may not be practical for macroeconomic effects to be incorporated in official estimates. But estimates of these effects should be provided as supplementary information for major tax and spending proposals. Dynamic estimation of policy changes should distinguish aggregate demand effects from aggregate supply effects, include long-run effects, apply to spending as well as tax changes, reflect the differing effects of various policy changes, account for the need to finance policy changes, and use a variety of models. Reform of entitlement programs remains the most pressing fiscal policy issue confronting the Nation.

Chapter 6, *Restoring Solvency to Social Security*, examines the largest entitlement program. Social Security is a pay-as-you-go system in which payroll taxes on the wages of current workers finance the benefits being paid to current retirees. While the program is running a small surplus at present, deficits are projected to appear in 15 years; by 2080, the Social Security deficit is projected to exceed 2.3 percent of GDP. These deficits are driven by two demographic shifts that have been underway for several decades: people are having fewer children and are living longer. The President has called for new initiatives to modernize Social Security to contain costs, expand choice, and make the program secure and financially viable for future generations of Americans.

This chapter assesses the need to strengthen Social Security in light of its long-term financial outlook. The most straightforward way to characterize the financial imbalance in entitlement programs such as Social Security is by considering their long-term annual deficits. Even after the baby-boom generation's effect is no longer felt, Social Security is projected to incur annual deficits greater than 50 percent of payroll tax revenues. These deficits are so large that they require a meaningful change to Social Security in future years. Reform should include moderation of the growth of benefits that are unfunded and would otherwise require higher taxes in the future. However, the benefits promised to those in or near retirement should be maintained in full. A new system of personal retirement accounts should be es-

tablished to help pay future benefits. The economic rationale for undertaking this reform in an era of budget deficits is as compelling as it was in an era of budget surpluses.

REGULATION

Chapter 7, *Government Regulation in a Free-Market Society*, discusses the role of the free market in providing for prosperity in the United States and considers situations in which Government interventions such as regulations would be beneficial. An important reason for Americans' high standard of living is that they rely primarily on markets to allocate resources. The Government enables the system to work by enforcing property rights and contracts. Typically, free markets allocate resources to their highest-valued uses, avoid waste, prevent shortages, and foster innovation. By providing a legal foundation for transactions, the Government makes the market system reliable: it gives people certainty about what they can trade and keep, and it allows people to establish terms of trade that will be honored by both sellers and buyers. The absence of any one of these elements—competition, enforceable property rights, or an ability to form mutually advantageous contracts—can result in inefficiency and lower living standards. In some cases, Government intervention in a market, for example through regulation, can create gains for society by remedying shortcomings in the market's operation. Poorly designed or unnecessary regulations, however, can actually create new problems or make society worse off by damaging the elements of the market system that do work.

Chapter 8, *Regulating Energy Markets*, discusses economic issues relevant to several energy markets, including natural gas, gasoline, electricity, and crude oil. While energy markets generally function well, some parts of the energy industry have characteristics associated with market failures. These could stem from the large fixed costs required to construct distribution networks for electricity and natural gas that give rise to *market power* in the form of a natural monopoly. Alternatively, the market may not function well in the presence of *negative externalities*, such as when energy producers and consumers do not fully take into account the fact that burning fossil fuels may cause acid rain or smog.

Minimizing disruptions is an important consideration in the design of regulations to address shortcomings in energy markets. Federal, State, and local regulations can have conflicting goals. If the conflicting goals are not balanced, competing regulations could lead to worse problems than the market failures the regulations attempt to address. Moreover, regulations need to be updated as markets evolve over time to ensure that their original goals still apply and that these regulations are still the lowest-cost means of meeting those goals.

The chapter also examines global trade in energy products. The United States benefits from international trade in energy products because meeting all U.S. energy needs from domestic sources would require significant and costly changes to the U.S. economy, including changes in the types of transportation fuels used by Americans. But this leads to the possibility of occasional supply disruptions. An important consideration is that the price of oil is set in global markets, so that disruptions to the supply of oil from areas that do not supply the United States affect domestic prices of oil even if U.S. imports are not directly affected. Fortunately, changes in the U.S. economy over the past three decades and the increasing sophistication of financial markets have diminished the impact of supply disruptions and temporary price changes on the United States.

Finally, the chapter considers the role for Government in subsidizing research and development into new energy sources. In general, policy makers should avoid forcing commercialization of new energy sources before market signals indicate that a shift is required. One potential problem with forcing this process is that technological breakthroughs may lead to alternatives in the future that are hard to imagine today. Premature adoption of new technologies would raise energy costs before the need arises, causing society as a whole to spend more on energy than needed.

Chapter 9, *Protecting the Environment*, discusses market-oriented approaches to safeguarding and improving the environment. While the free-market system typically promotes efficiency and economic growth, the absence of property rights for environmental "goods" such as clean air and water can lead to negative externalities that reduce societal well-being. This problem can be addressed by establishing and enforcing property rights that will lead the interested parties to negotiate mutually beneficial outcomes in a market setting. If such negotiations are expensive, however, the Government can design regulations that consider both the benefits of reducing the environmental externality as well as the costs of the regulations.

Regulations should be designed to achieve environmental goals at the lowest possible cost, promoting both environmental protection and continued economic growth.

Indeed, economic growth can lead to increased demand for environmental improvements and provide the resources that make it possible to address environmental problems. Some policies aimed at improving the environment can entail substantial economic costs. Misguided policies might actually achieve less environmental progress than alternative policies for the same cost. Environmental risks should be evaluated using sound scientific methods to avoid possible distortions of regulatory priorities. Market-based regulations, such as the cap-and-trade programs promoted by the Administration to reduce common air pollutants, can achieve environmental goals at lower cost than inflexible command-and-control regulations.

REFORMS OF HEALTH CARE AND THE LEGAL SYSTEM

Chapter 10, *Health Care and Insurance*, discusses the roles of innovation, insurance, and reform in the health care market. U.S. markets provide incentives to develop innovative health care products and services that benefit both Americans and the global community. The breadth and pace of innovation in the provision of health care in the United States over the past few decades have been astounding. New treatment options, however, have also been associated with higher costs and concerns about affordability. Research suggests that between 50 and 75 percent of the growth in health expenditures in the United States is attributable to technological progress in health care goods and services. A strong reliance on market mechanisms will ensure that incentives for innovation are maintained while providing high-quality care in the most costefficient manner.

Health insurance plays a central role in the workings of the U.S. health care market. An understanding of the strengths and weaknesses of health insurance as a payment mechanism for health care is essential to the design of reforms that retain incentives for innovation while reining in unnecessary expenditures. Over-reliance on health insurance as a payment mechanism leads to an inefficient use of resources in providing and utilizing health care. Reforms should provide consumers and health care providers with more flexibility, more choices, more information, and more control over their health care decisions.

Chapter 11, *The Tort System*, discusses the role of the U.S. tort system and the considerable burden it imposes on the U.S. economy. The tort system is intended to compensate accident victims and to deter potential defendants from putting others at risk. Empirical evidence, however, is mixed on whether the tort system effectively deters negligent behavior. Moreover, the tort system is a costly method of providing insurance against a limited number of injuries. Research suggests that tort liability also leads to lower spending on research and development, higher health care costs, and job losses.

Ways to reduce the burden of the tort system include limits on noneconomic damages, class action reforms, trust funds for payments to victims such as in asbestos, and allowing parties to avoid the tort system contractually. The Administration has proposed a number of reforms to reduce the burden of the tort system while ensuring that people with legitimate claims can recover damages.

INTERNATIONAL TRADE AND FINANCE

Chapter 12, *International Trade and Cooperation*, discusses how growing trade helps to spur U.S. and global growth. Since the end of the Second World War, international trade has grown steadily relative to overall economic activity. Over time, countries that have been more open to international flows of goods, services, and capital have grown faster than countries that were less open to the global economy. The United States has been a driving force in constructing an open global trading system. The Administration has pursued, and will continue to pursue, an ambitious agenda of trade liberalization through negotiations at the global, regional, and bilateral levels.

New types of trade deliver new benefits to consumers and firms in open economies. Growing international demand for goods such as movies, pharmaceuticals, and recordings offers new opportunities for U.S. exporters. A burgeoning trade in services provides an important outlet for U.S. expertise in sectors such as banking, engineering, and higher education. The ability to buy less expensive goods and services from new producers has made household budgets go further, while the ability of firms to distribute their production around the world has cut costs and thus prices to consumers. The benefits from new forms of trade, such as in services, are no different from the benefits from traditional trade in goods. Outsourcing of professional services is a prominent example of a new type of trade. The gains from trade that take place over the Internet or telephone lines are no different than the gains from trade in physical goods transported by ship or plane. When a good or service is produced at lower cost in another country, it makes sense to import it rather than to

produce it domestically. This allows the United States to devote its resources to more productive purposes.

Although openness to trade provides substantial benefits to nations as a whole, foreign competition can require adjustment on the part of some individuals, businesses, and industries. To help workers adversely affected by trade develop the skills needed for new jobs, the Administration has worked hard to build upon and develop programs to assist workers and communities that are negatively affected by trade.

The Administration has also worked to strengthen and extend the global trading system. International cooperation is essential to realizing the potential gains from trade. Trade agreements have reduced barriers to international commerce, and contributed to the gains from trade. A system through which countries can resolve disputes can play an important role in realizing these gains.

Chapter 13, *International Capital Flows*, discusses the economic benefits and risks associated with the transfer of financial assets, such as cash, stocks, and bonds, across international borders. Capital flows have become an increasingly significant part of the world economy over the past decade, and an important source of funds to support investment in the United States. Around \$2 trillion of capital flowed into all countries in the world in 2002, with around \$700 billion flowing into just the United States. Different types of capital flows—such as foreign direct investment, portfolio investment, and bank lending—are driven by different investor motivations and country characteristics. Countries that permit free capital flows must choose between the stability provided by fixed exchange rates and the flexibility afforded by an independent monetary policy.

Capital flows can have a number of benefits for economies around the world. For example, foreign direct investment can facilitate the transfer of technology, allow for the development of markets and products, and improve a country's infrastructure. Portfolio flows can reduce the cost of capital, improve competitiveness, and increase investment opportunities. Bank flows can strengthen domestic financial institutions, improve financial intermediation, and reduce vulnerability to crises.

A series of financial crises in emerging market economies, however, has raised some concerns that financial liberalization can also involve risks. In countries with weak institutions, poorly regulated banking systems, or high levels of corruption, capital inflows may not be channeled to their most productive uses. One approach to limiting the risks from capital flows when legal and financial institutions are poorly developed is to restrict foreign capital inflows. Experience suggests, however, that capital controls impose substantial, and often unexpected, costs. Instead, countries are more likely to benefit from free capital flows and minimize any related risks, if they adopt prudent fiscal and monetary policies, strengthen financial and corporate institutions, and develop sound regulations and supervisory agencies. The Administration has promoted policies to help countries reap the benefits from the free flow of international capital.

Chapter 14, *The Link Between Trade and Capital Flows*, shows that trade flows and capital flows are inherently intertwined. Changes in a country's net international trade in goods and services, captured by the current account, must be reflected in equal and opposite changes in its net capital flows with the rest of the world. The large net inflow of foreign capital experienced by the United States in recent years has funded more investment than could be supported by U.S. national saving. Corresponding to these inflows is the large U.S. current account deficit. These patterns reflect fundamental economic forces, notably strong growth in the United States that has made investment in this country attractive compared to opportunities in other countries.

An adjustment of the U.S. current account deficit could come about in several ways. Faster growth in other countries relative to the United States could increase demand for U.S. net exports. Trade flows could also adjust through changes in the relative prices of U.S. goods and services compared to the prices of foreign goods and services. Any reduction in the U.S. current account deficit would also require reduced net capital inflows into the United States. This might occur if U.S. national saving increased, reducing the need for foreign funds to finance U.S. domestic investment, or if U.S. investment declined, so that the United States required less capital inflows. Lower investment is the least desirable form of balance of payments adjustment, however, as it could slow the expansion of U.S. productive capacity and reduce economic growth.

It is impossible to predict the exact timing or magnitude of any adjustment in the U.S. current account balance. After a large increase in the U.S. current account deficit in the 1980s, the ensuing adjustments were gradual and benign. Public policies can facilitate smooth changes in the U.S. current account and net capital flows by

creating a stable macroeconomic and financial environment, promoting growth abroad, and encouraging greater saving in the United States.

CONCLUSION

The future of the U.S. economy is bright. This is a testament to the institutions and policies that have unleashed the creativity of the American people and their spirit of entrepreneurship. History teaches that the forces of free markets are the bedrock of economic prosperity.

In 1776, as the Founding Fathers signed the Declaration of Independence, the great economist Adam Smith wrote: "Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism but peace, easy taxes, and a tolerable administration of justice: all the rest being brought about by the natural course of things." The economic analysis presented in this Report builds on the ideas of Smith and his intellectual descendants by discussing the role of the Government in creating an environment that promotes and sustains economic growth.

